The City of Lynchburg, Virginia

MEMORANDUM

To: City Council
From: Michael W. Hill, Director of Financial Services
Date: October 25, 2004
Subject: Financial Trend Monitoring System (FTMS)

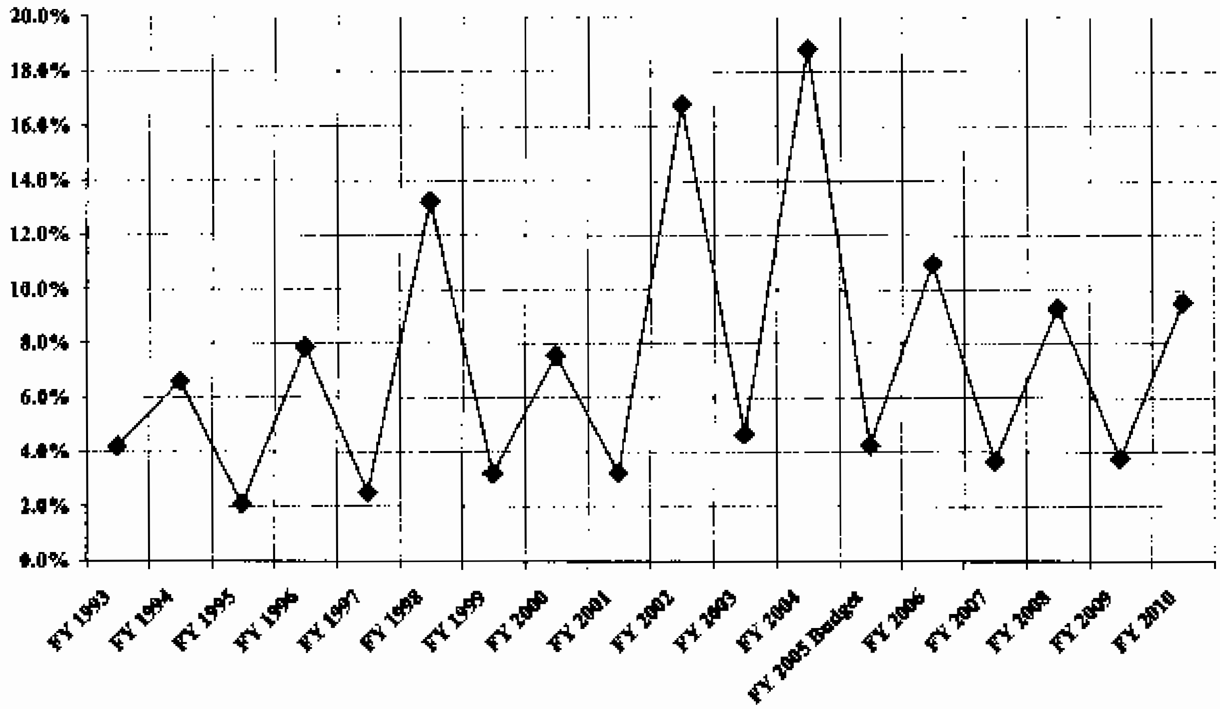
The ability to evaluate the financial condition of the City whether by essential decision-makers within the City, taxpayers, rating agencies is critically important. A tool that has been utilized by many local governments is the Financial Trend Monitoring System (FTMS) developed by the International City/County Management Association (ICMA). One important advantage of this system is that the analytical techniques it includes follow many of the same approaches used by the municipal credit rating industry. These techniques can help the City analyze and interpret its' financial condition. Trend analysis is critical in understanding and evaluating the City's financial condition. It also allows for a better understanding where the City has been, but more important, it provides a basis for more effective long-range planning. Such analysis can provide early warning signals of potential or emerging financial problems.

As the attached information is reviewed, there are a number of considerations that are important to understand the trend data:

- Warning Trend
  With each chart/indicator there is a warning trend which serves as a benchmark to evaluate the City's past performance/trend.
- Consumer Price Index
  Where appropriate, trend data has been adjusted for changes in the Consumer Price Index to reflect past performance in constant dollars.
- Future Revenue
  Based on past trends and the current economic conditions, revenues have been increased an average of two percent.
- Future Operating Expenditures
  Expenditures have been increased at two percent per year for the period July 1, 2006 through June 30, 2010.
- Future Debt Service
  Future debt service is based on the FY 2005-2009 Council-adopted Capital Improvement Program.

The purpose of presenting this information is to provide a snapshot of the City's financial past and projections for the future based on certain assumptions. Based on future projections, significant financial challenges are ahead.

Percentage Change In Assessed Valuation



Warning Trend:

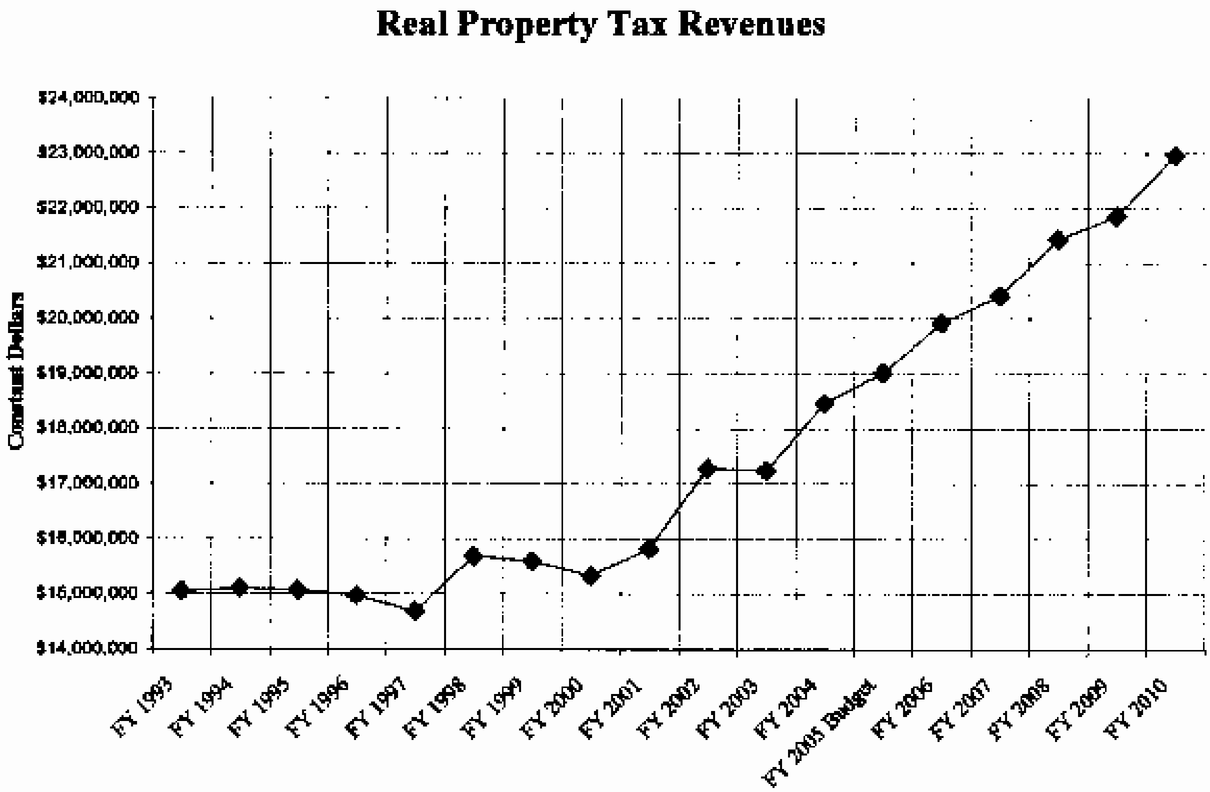
Declining or stagnant Real Property Tax Values (constant dollars)

Description:

Real Property is taxed at $1.11 per $100 of assessed valuation

Analysis:

Real Property is reassessed bi-annually which is reflected in the increase in alternate fiscal years on the chart. The large increase in FY 1998 was the result of a bi-annual reassessment year that also included the first full real property assessment for the Frito-Lay manufacturing facility. In FY 2002, another large increase was realized from: (a) bi-annual reassessment, (b) first full real property assessment for a large portion of new retail development along the Wards Road corridor, and (c) the first year proration of property assessments for completed construction. Prior to FY 2002 partially and completed construction was not recognized until the next year's assessment which could result in a loss of tax revenue of up to one year depending upon when construction was completed. The average percentage increase from FY 1993 to FY 2004 was 4.7%. For FY 2004, a reassessment year, an increase of 10.6% was realized. For FY 2005-FY 2010 a 5% increase is assumed for reassessment years with a 2% increase for non-reassessment years based on new construction trends.



Warning Trend:

Declining or stagnant real property tax revenues

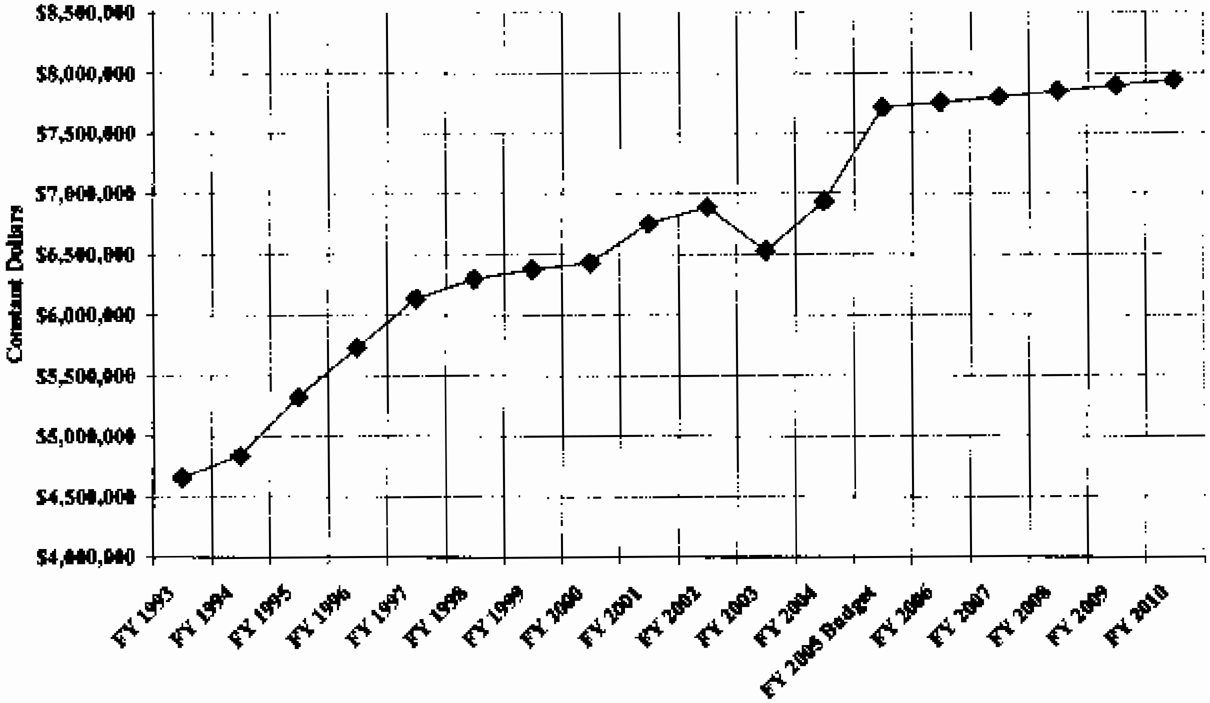
Description:

Real property is taxed at $1.11 per $100 of assessed valuation.

Analysis:

For the period FY 1993 through FY 1997 Real Property Tax revenues were constant with a slight decline in FY 1997. During this period the Real Property Tax rate was reduced from $1.18/$100 to $1.16 in FY 1996, and from $1.16 to $1.13 in FY 1997. Further, although revenue increased in FY 1998, the Real Property Tax rate was reduced from $1.13 to the current rate of $1.11. In FY 2002, the increased revenue was attributable to: (a) bi-annual reassessment, (b) the first full year of real property assessment for a large portion of new retail development along the Wards Road corridor, and (c) the first year proration of property assessments for partially completed and completed construction. The average annual increase since FY 1993 has been .8%. The large increase in FY 2004 was the result of a 10.6% increase in assessments. No change in the Real Property Tax rates is assumed for future years; however, revenues are projected to increase from changes in assessments.

Personal and Business Property Tax Revenue



Warning Trend:

Decrease in yearly levy or notification of business closings

Description:

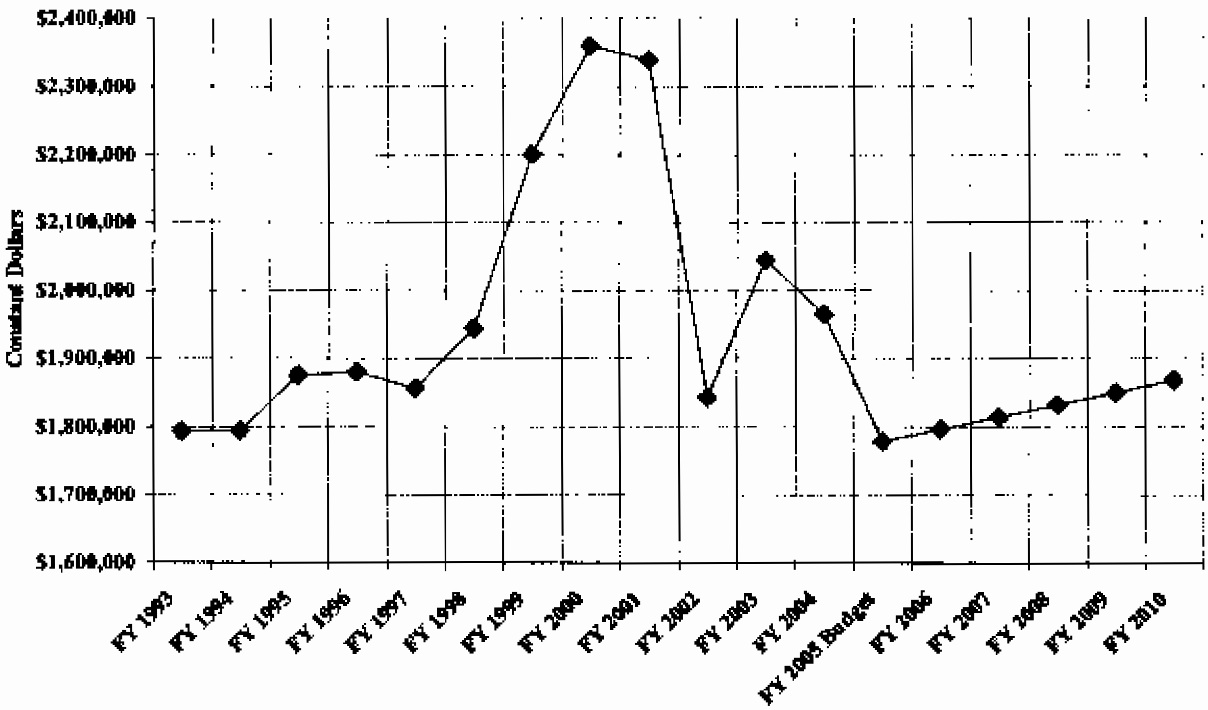
The current personal property tax rate is $3.80 per $100 of assessed valuation
Personal Property is assessed at 100% of trade-in value
Business Personal Property is assessed as follows:

Equipment, 1-5 years of age is assessed at 30% of cost.
Equipment greater than 5 years of age is assessed at 25.35% of cost.

Analysis:

Average annual growth for Personal and Business Property Tax revenue since FY 1993 has been 2.4%. This revenue includes receipts from the Commonwealth of Virginia's Personal Property Tax Relief Act which began in FY 2000. The increase in the FY 2005 Budget reflects the impact of the of the $.5 million reduction in NADA values and the rate increase from $3.30 to $3.80 per $100 of assessed valuation. Because of the downturn in the economy, and unemployment from recent layoffs, growth has been assumed at 1% per year for future years.

Machinery and Tools Tax Revenue



Warning Trend:

Declining or stagnant Machinery and Tool Tax Revenues

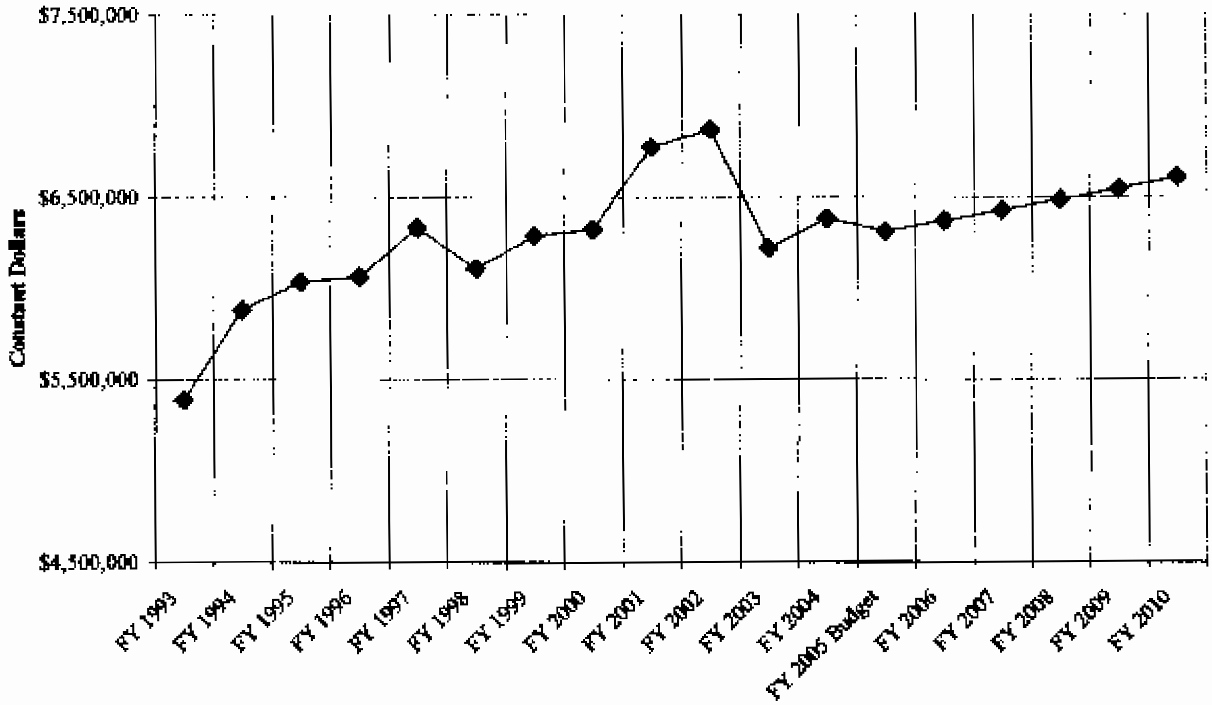
Description:

The current tax rate is $3.00 per $100 of assessed valuation.
There is no cap imposed by the State Code.
Equipment, 1-5 years of age is assessed at 30% of cost.
Equipment greater than 5 years of age is assessed at 25.35% of cost.

Analysis:

The increase in Machinery and Tools Tax revenue beginning in FY 1998 was a result of an expanding economy in the late 1990's. During this period there were several manufacturing expansions that resulted in increased revenue. However, in FY 2002, as the economy weakened, the City experienced a major revenue loss of the same Machinery and Tool Tax revenue that increased from FY 1998 through FY 2001 from Ericsson. In addition to the revenue loss from Ericsson, Rock-Tenn changed its production process that resulted in eliminating two production lines and related equipment. These two events resulted in a loss of over $700,000 in revenue. A portion of the Rock-Tenn revenue loss was recovered in FY 2003 with installation of new manufacturing equipment. The decline in revenue for FY 2005 reflects the final revenue loss from Ericsson and Sammina closings. The average annual percentage increase from FY 1993 to FY 2003 is 1.7%. Future growth is assumed at 1% per year.

Sales Tax Revenue



Warning Trend:

Declining or stagnant Sales Tax Revenues

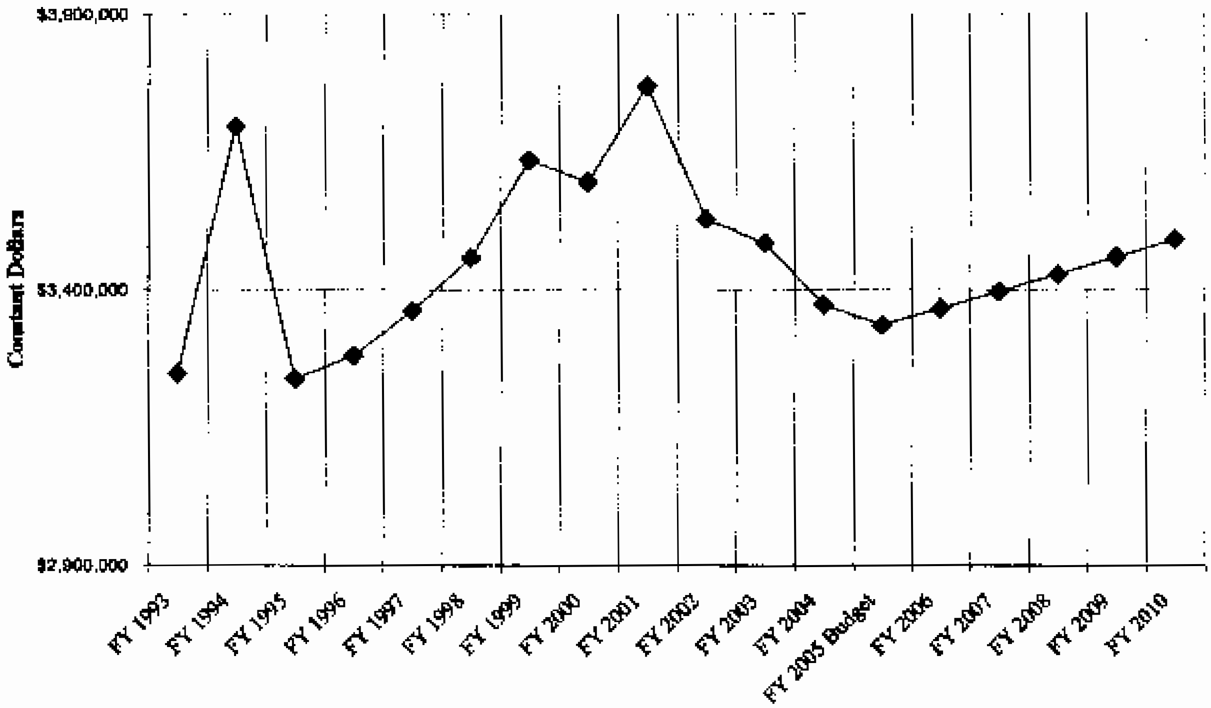
Description:

Sales Tax revenue to the City is 1% of the 5.0% total sales tax charged at the time of sale.

Analysis:

Sales Tax has experienced moderate growth from FY 1993 to FY 2003 with average annual increases of 1.2% during this period. As a result of the new business development along Wards Road, a sharp revenue increase was realized during FY 2000 and FY 2001. The small increase in FY 2002 from FY 2001 is due to a one-time adjustment overlooked by the external auditors. Discounting this adjustment, the increase from FY 2001 to FY 2002 reflected virtually no growth. The decline from FY 2002 to FY2003 was attributable to the economic downturn during the past few years. During the last quarter of FY 2004, sales tax revenue rebounded from the same period of FY 2003. For the period FY 2006 through FY 2010 a 1% growth rate has been assumed.

Business License Tax Revenue



Warning Trend:

Declining or stagnant Business License Tax Revenues

Description:

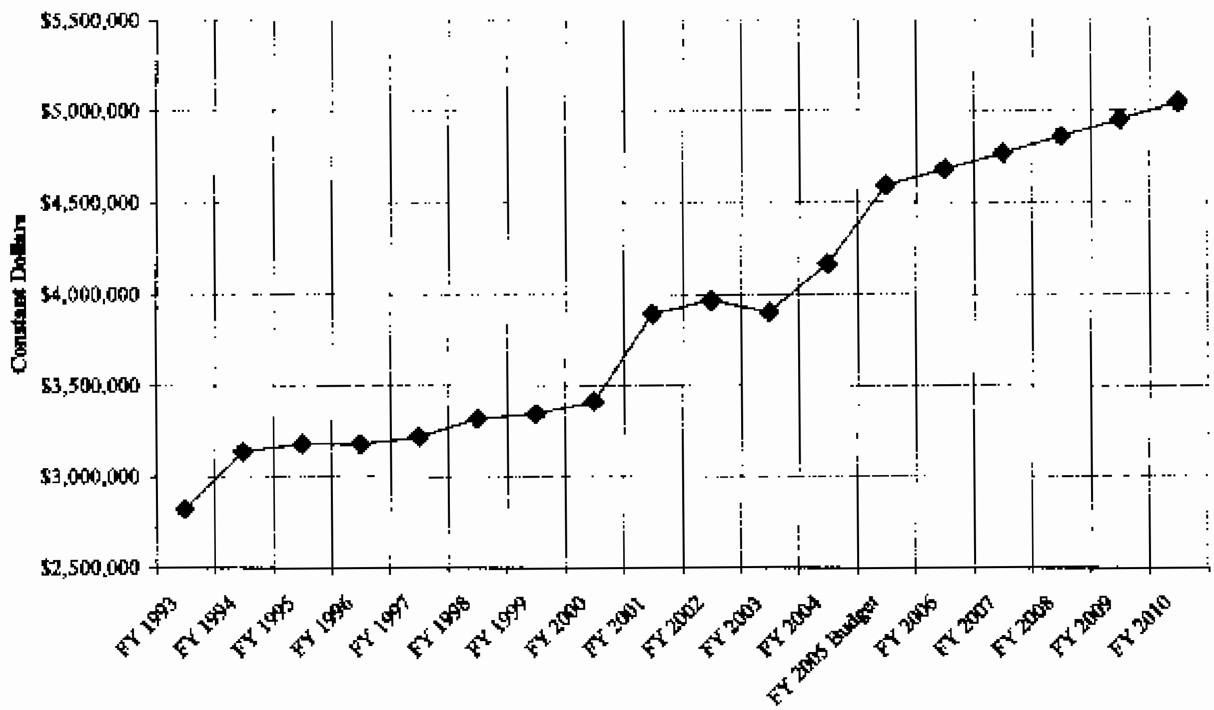
Business Licenses are assessed on the gross receipts of the business at the maximum rate allowed by the State Code:

- $.0020 per $100 retail;
- $.0028 per $100 wholesale;
- $.0016 per $100 contractor;
- $.0036 per $100 business service; and
- $.0058 per $100 professional service.

Analysis:

Consistent with the economy, revenue from the Business License Tax experienced steady growth until the economic downturn began in the past few years. The increase in FY 2001 was primarily attributable to the retail development along the Wards Road corridor. The average annual increase since FY 1993 is .9%. Because of the sluggish economy, future growth is estimated at 1%.

Meals Tax Revenue



Warning Trend:

Declining or stagnant Meals Tax Revenues

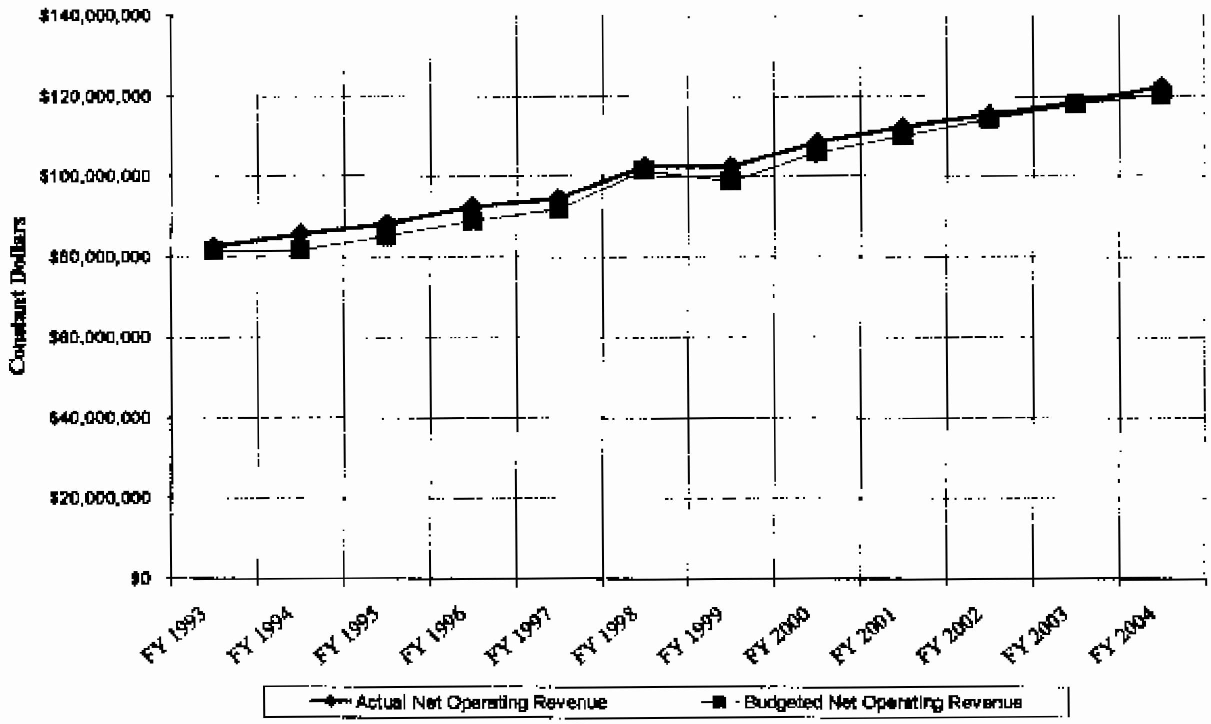
Description:

Meals tax is 6.5% of the cost of the meal. There is no cap imposed by the State Code.

Analysis:

The average annual growth in Meals Tax from FY 1993 to FY 2003 was 2%. In FY 2001, the sharp increase in revenue was attributable to a .5% increase in the Meals Tax rate from 5.5% to 6%. During FY 2002, restaurant development continued along the Wards Road corridor sustaining growth in this revenue source. The FY 2004 revenue projection was increased to reflect new restaurants along the Wards Road corridor as well as annualizing the additional revenue for future revenue projections from these new restaurants. The increase from FY 2004 to FY 2005 is the result of the rate increase from 6% to 6.5%. For the period FY 2006 through FY 2010, a 2% growth rate is assumed.

Revenue Shortfall or Surplus



Warning Trend:

Increase in revenue shortfalls as a percentage of actual net operating revenues

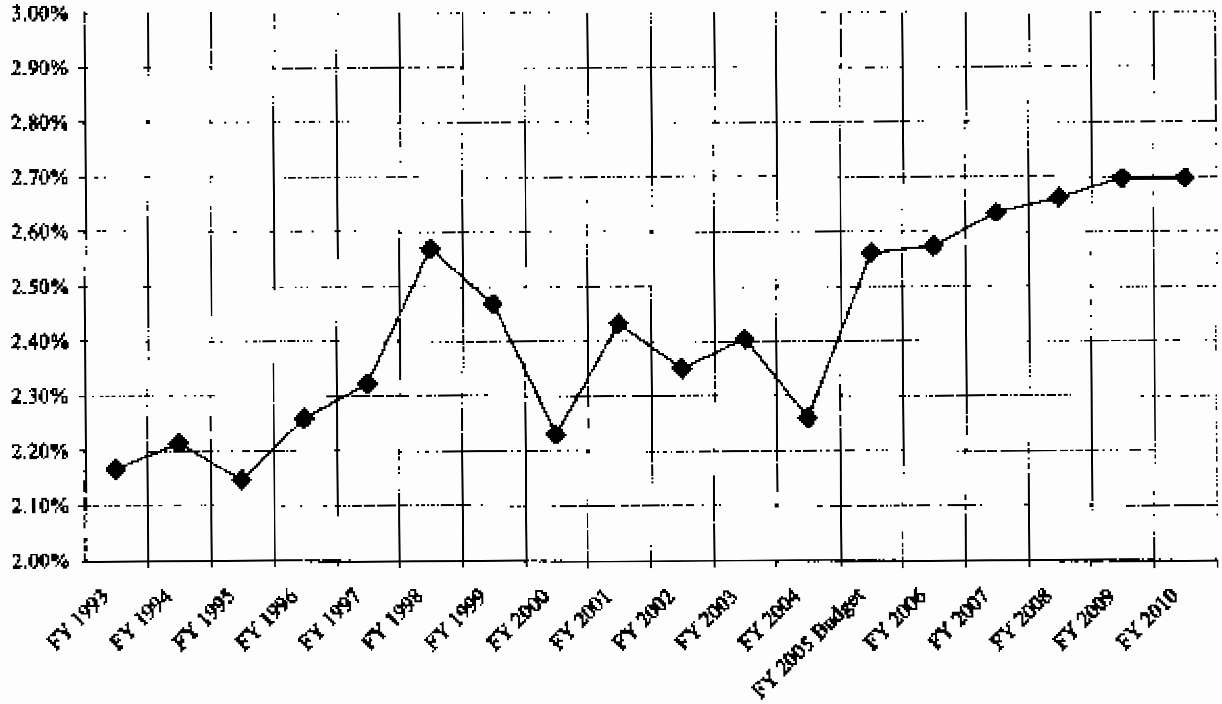
Description:

Actual net revenues are compared to budgeted revenues.

Analysis:

For the period FY 1993 through FY 2002 the performance of actual revenues has been greater than the budget. This is a positive trend with increased revenues accruing to the General Fund, however, since FY 1999, the variation between budget and actual revenues has narrowed. In FY 2003 there was a slight shortfall. This narrowing of the gap between budgeted revenues and actual revenues reflects the uncertainty of the economy as well as more refined budget projections. For FY 2004 there was a slight increase in actual revenue compared to the budget. Fluctuations in part are attributed to unanticipated revenues such as (a) FEMA funding for the 1993 ice storm received in FY 1994, (b) State funding for the 1993 wind storm received in FY 1994, (c) funding from the Governor's Fund for Frito-Lay in 1998 and Ericsson 1999. Even without the one-time monies, revenue surpluses were realized. It is projected that the gap between budgeted revenues and actual revenues will continue.

Long Term Debt As A Percentage of Assessed Valuations



Warning Trend:

Increasing long-term debt as a percentage of assessed valuation

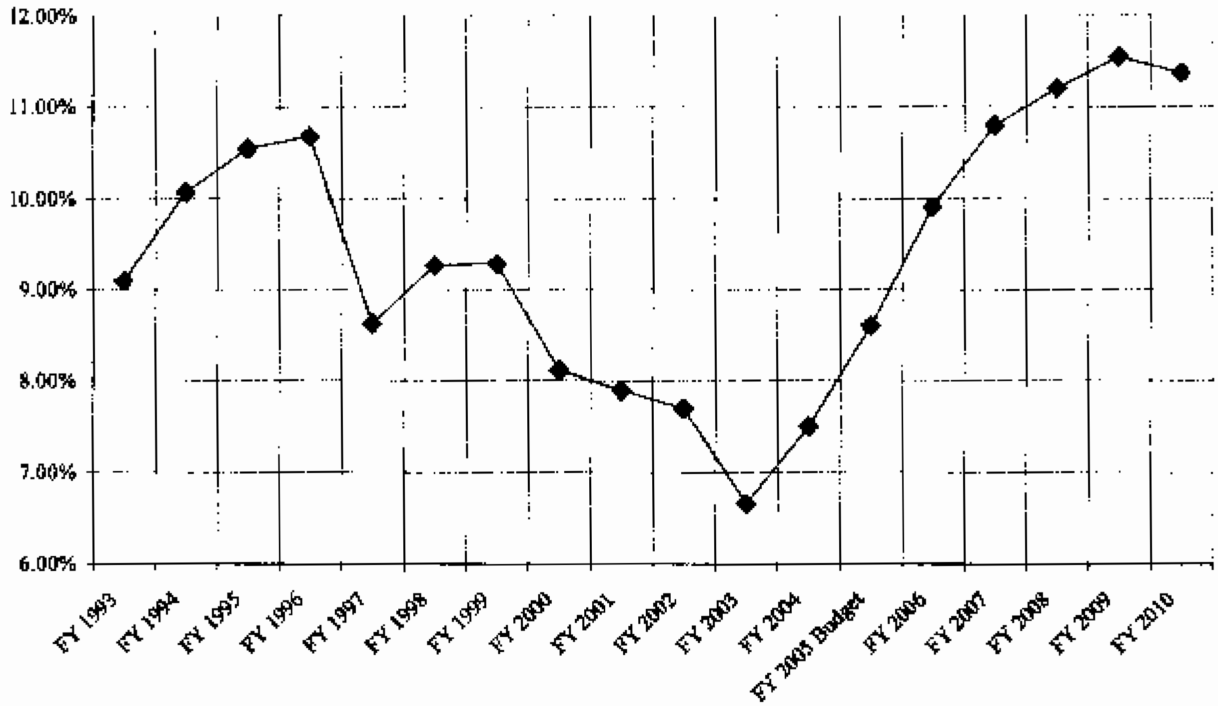
Description:

The Council-adopted financial policy provides that tax-supported debt will not exceed 5% of the assessed valuation of taxable property. The State Code provides a limit of 10% of taxable property.

Analysis:

For the period FY 1993 through FY 2004, long-term debt has been below 2.6%. This is well within the financial policy limits and is viewed very favorably by the bond rating agencies. With the increased borrowing for school construction, it is projected that it may increase to almost 2.7%. The large increase from FY 2004 to FY 2005 is the result of scheduling the FY 2004 bond issue resulting in a lag of when it will be reflected in the City's outstanding indebtedness.

City and School Debt Service



Warning Trend:

Increasing debt service as a percentage of expenditures

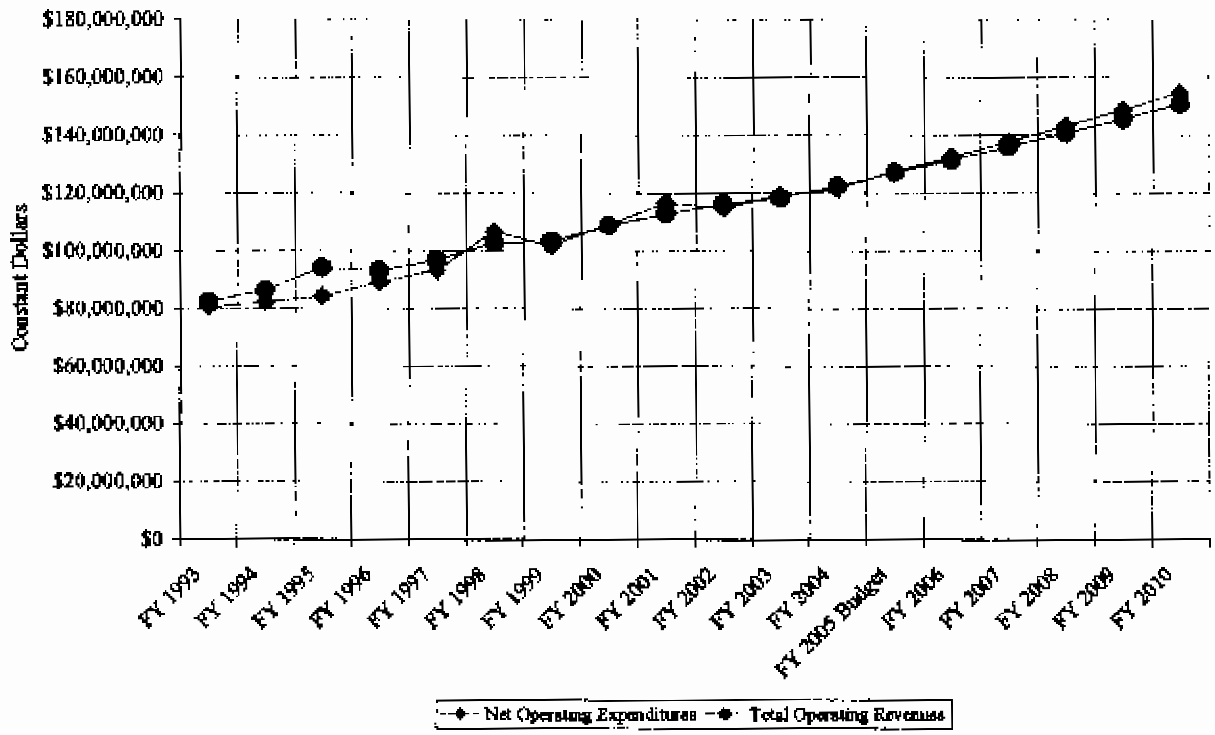
Description:

The Council-adopted financial policy provides that annual debt service for tax-supported debt should not exceed 10% of total General Fund Expenditures plus (a) transfers to the School Operating Fund and (b) Reserve Allocations.

Analysis:

The City adopted several financial policies in FY 2000 that have provided guidance in the management of municipal finances one of which was in the area of debt management. From FY 1994 through FY 1996, the City exceeded what is now the 10% limit. Through the guidance of the debt policy for the past several years, annual debt service has been below the 10% limit. With the increased borrowing for schools, particularly E. C. Glass, the City may exceed the 10% threshold for a few years. This has been discussed with the bond rating agencies and they view the renovation of E. C. Glass as a one-time event as it is not likely that a new high school will be constructed in Lynchburg in the future. The large increase from FY 2004 to FY 2005 is the result of scheduling the FY 2004 bond issue resulting in a lag of when it is reflected in the annual budget. The estimated future debt service is based on the FY 2005-2009 Capital Improvements Program.

Operating Revenues and Expenditures



Warning Trend:

Increasing gap between revenues and expenditures

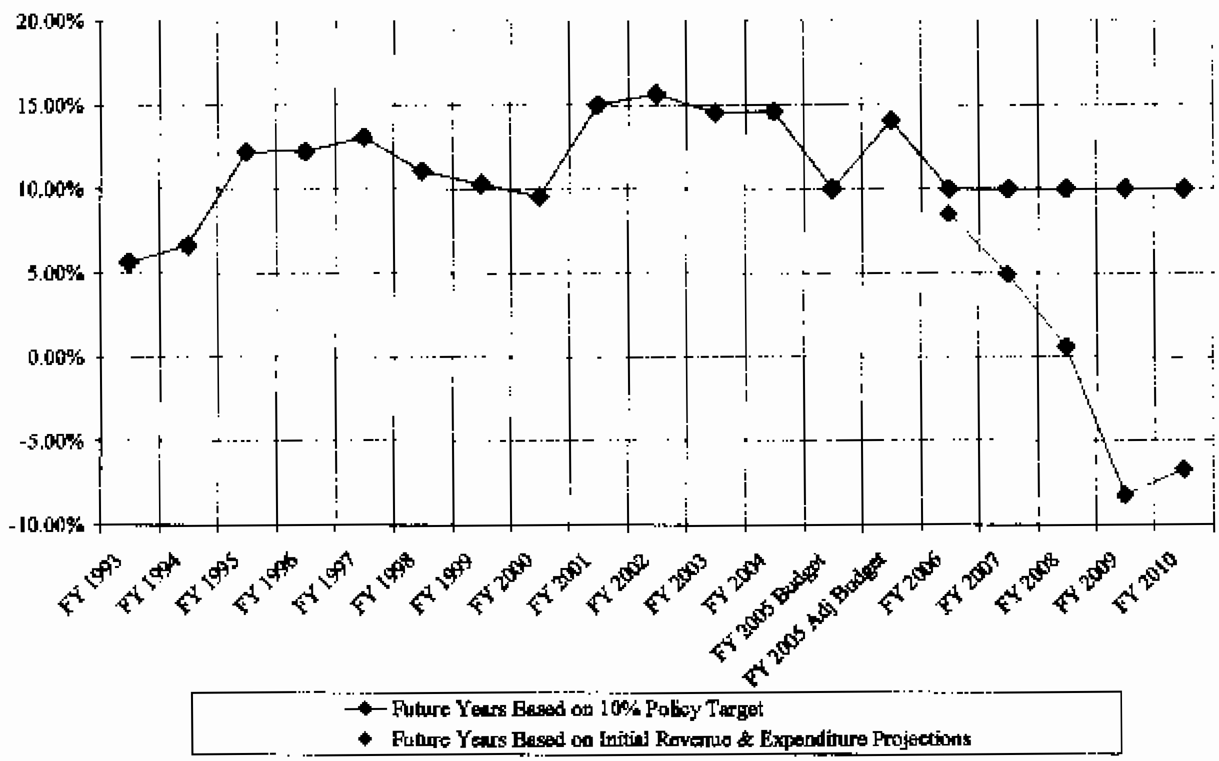
Description:

The Council-adopted budget policy provides that recurring expenditures are supported by recurring revenues.

Analysis:

Actual increases for the period FY 1993 to FY 2004 averaged 3.9% for expenditures and 3.5% for revenues. Based on these assumptions for future years, expenditures are projected to exceed revenues with the gap increasing in the future.

Fund Balance



Warning Trend:
Declining undesignated fund balance as a percentage of revenues
Description:
The Council-adopted financial policies provide that the City will maintain a minimum Undesignated General Fund Balance equal to 7% of General Fund revenues, with a targeted goal equal to 10% of General Fund revenues. In the event the Undesignated General Fund Balance is used to provide for temporary funding of unforeseen emergency needs, the City shall restore the Undesignated General Fund Balance to the minimum of 7% within 2 fiscal years. If the Undesignated General Fund Balance falls below the target of 10%, the City shall restore the Undesignated General Fund Balance to the 10% target within 5 fiscal years.
Analysis:
This chart presents fund balance trend from FY 1993 to FY 2004. Although formal policies were not adopted until FY 2000, since FY 1995 the General Fund Balance has been at or above 10% except for a slight variance in FY 2000. For FY 2004 the General Fund ended the year with a balance of 14.6%. Applying this actual balance to the adopted budget would yield a FY 2005 adjusted beginning balance of 14.0%. Two future scenarios are noted above. One assumes that City Council will maintain a minimum 10% fund balance. A second reflects the fund balance impact based on initial future revenue and expenditure projections utilizing prior year average increases.